

**REPORT OF THE DEPARTMENT OF THE TREASURY**  
**ON**  
**EMPLOYER STOCK IN 401(k) PLANS**



---

February 28, 2002

## **Executive Summary**

The Department of the Treasury, as head of the President's Retirement Security Task Force, has undertaken a review and analysis of the impact of placing a percentage cap on employer stock holdings by 401(k) participants. In formulating its conclusions, the Treasury Department has examined information provided by the Department of Labor, reviewed surveys of 401(k) participants conducted by the Employee Benefits Research Institute (EBRI) and the Investment Company Institute, and held discussions with a number of benefit administrators of plans that hold employer stock. Based on this review, the Department concludes that placing arbitrary caps on individual 401(k) account holdings in employer stock would have a widespread impact on 401(k) plan participants and potentially severe disruptive effects on the stock prices of several major companies. Data show that as many as 1 in 5 of 401(k) participants would be forced to change their investment allocations if employer stock holdings were limited to 20 percent. Moreover, at one major company, for example, enforcement of a 20 percent limit on employer stock holding would precipitate the sale of hundreds of millions of shares, an amount equal to almost 16 times the daily trading volume. At another company, it would be 37 times daily trading volume.

## **Background and History**

Pension schemes in the United States have always been voluntary. Private pensions, as a form of employee compensation, have been a competitive tool employed by firms to attract employees. The nation's pension system has evolved in recent years into one that emphasizes two of the country's quintessential values: personal responsibility and freedom of choice. This evolution provides workers much greater opportunity than ever before to build retirement savings, but also imposes a greater degree of individual responsibility in preparing for retirement.

Since 1974 the labor and financial markets have undergone major change. As the economy has evolved from one based on heavy industry to one based on the provision of information and services, the work force has become increasingly mobile and highly educated. For the typical American worker, job and even career changes have become commonplace. During the same period, as a result of deregulation, financial markets have made a wide array of new investment vehicles available to consumers. This has provided the average consumer the opportunity to build wealth through a broader range of investments offering higher rates of return for long-term savings than the traditional passbook account. As the relationships between workers and employers and consumers and financial markets have evolved so has the pension system. This is reflected through current federal policies that provide incentives for retirement wealth development through tax advantaged portable vehicles like Individual Retirement Accounts and defined contribution plans.

Since today's workers are less likely to be tied to an individual firm for their entire careers than their parents were, they must increasingly look to their own resources to build sufficient wealth for a secure retirement. Today's workers need plans that allow them to undertake retirement planning independently. Under defined benefit plans, most retirement

planning and investment decisions are left to the employer. Pension contributions for employees are placed in a common fund that is controlled by the employer. The employer decides on the size of contributions, their timing, and the choice of assets in which the fund is invested. This results in a one-size-fits-all type of system that does not account for differences in employees' preferences for saving and the timing of consumption during their lifetime. And because all contributions become part of a consolidated overall fund, employees may have no sense of ownership of pension assets and no feeling of building personal wealth for the future. Since defined benefit plans are tied directly to employment with a specific firm they tend not to be portable when employees change jobs. Defined benefit plans offer the advantage of security in that benefits are guaranteed at a certain level. However, moving to a new job from one with a defined benefit plan often means a major sacrifice in future benefits, whether or not the move is voluntary.

### *Defined Contribution Plans*

Defined contribution plans, about half of which are 401(k) plans, return most decision making to the individual.<sup>1</sup> Under a defined contribution plan individual employees have their own accounts in which they can build their own wealth. Employees are allowed, within limits set in the tax code, to choose the level of their pension plan contributions. In order to encourage higher rates of retirement saving, these limits were expanded by the Economic Growth and Tax Relief Reconciliation Act signed by the President last year.

Employees also have more latitude in choosing the timing of contributions with defined contribution plans. As an individual's circumstances change, 401(k) plans allow for higher contributions in some years than others. In virtually all plans, employees have the ability to choose the investment options in which their own contributions are invested, and in many others they can allocate both their own and their employer's contributions into investments of their own choosing. This freedom to allocate among investments allows employees to choose the tradeoff between risk and return that suits them best. It also allows individuals to adjust their portfolios from one with higher potential returns and higher risk early in their careers to one that provides smaller but surer returns as they approach retirement.

### *The Role of Employer Stock in Defined Contribution Plans*

Employer stock is an integral part of many 401(k) plans, particularly among those sponsored by America's largest firms. It may be offered as one of a number of investment options to which employees may allocate 401(k) assets. Employers may make matching contributions to employees' accounts in the form of company stock. Employees may be given specific incentives to invest in company stock. For example, some firms offer matches in the form of company stock or cash, but provide a higher match if the employee chooses his or her employer's stock. Some plans allow employees to sell matching contributions of employer stock

---

<sup>1</sup> For purposes of this report we will refer to 401(k) plans, but the discussion and recommendations generally apply to all defined contribution plans. There are about 50 million defined contribution plan participants, of which about 42 million are 401(k) participants. Some workers may participate in more than one type of defined contribution plan.

at any time. Other plans require that employer stock provided by the employer as a matching contribution be held for an extended period of time.

Providing matching contributions in the form of company stock can have a number of benefits for both employers and employees. Companies may benefit from tax and cash flow advantages. Many companies believe that giving employees company stock builds their employees' loyalty to the company and gives them a greater economic incentive to work to promote the company's long-term economic prospects. Employees benefit directly when employers provide greater matching contributions to their 401(k) accounts. Also, research shows that employees themselves are more likely to participate in their company's 401(k) plan when their employer offers matching contributions.

Most defined contribution plans that include employer stock as an investment option or as a matching contribution are found in very large companies. For instance, for plans with fewer than 500 participants, the overall percentage of assets held in employer stock is less than 1 percent. In contrast, for plans with more than 5,000 participants, the overall percentage of assets held in employer stock is 26.6 percent. Large companies are also the ones more likely to offer their workers other retirement savings vehicles such as a defined benefit pension plan.

### **Issues and Conclusion**

Recently introduced legislation on retirement security proposes to limit the holdings of company stock by individual plan participants in their 401(k) accounts. These proposed limits are expressed as a maximum percentage of the value of all 401(k) assets that an individual can hold in the form of company stock. The caps that have been discussed are 10 percent, which is the limit placed on company stock in defined benefits plans, or 20 percent. The proposals exempt employee stock ownership plans (ESOPs) from these restrictions.

In preparing its recommendations on enhancing retirement security, the President's Retirement Security Task Force sought to enhance workers' investment options, including their ability to diversify their 401(k) accounts according to their individual situations. The Task Force rejected the idea of imposing federal limitations on those options by arbitrarily setting a ceiling on the amount of employer stock a worker may hold in his or her own 401(k) plan. Also, the Task Force wanted to avoid establishing rules that discouraged employers from matching workers' own contributions to their 401(k) accounts. The Task Force -- and the President -- concluded that the most appropriate public policy is to give workers as much flexibility as possible while encouraging employers to provide matching contributions, and to give employees regular disclosures regarding their accounts and financial education so that employees make informed investment decisions.

The next section explains the President's proposal and the following section sets forth in greater detail why the Administration opposes arbitrary, federally imposed caps on workers' holdings of employer stock in their 401(k) plans.

## **The President's Recommendation for Enhancing Worker Choice**

Asset diversification is a bedrock principle of prudent long-term investing. Congress established 401(k) plans to promote individual retirement saving. But a plan requirement mandating that all or a portion of an employee's 401(k) account be invested in employer stock runs counter to this diversification principle. Concentration of employer stock in a worker's retirement plan creates a double risk for workers -- if their company fails, they lose their jobs and that portion of their retirement savings. At the same time, employer matching contributions are a form of compensation and as such an employee should have a right to invest them as the employee sees fit.

The President has recommended that Congress require that employees be free to sell company stock contributed to their 401(k) plan by their employer at any time after they have been participating in the company's 401(k) plan for three years. An employee stock ownership plan (ESOP) will not be subject to the diversification rules as long as no (1) participant elective contributions (i.e. 401(k) contributions), (2) matching contributions, or (3) employer contributions which are used to pass the 401(k) nondiscrimination tests, are made to the plan.

This change balances the desire of some companies to offer company stock as matching contributions with employees' freedom to pursue a retirement savings plan appropriate to their situations. Allowing employees to freely hold or sell employer stock would have a disciplining effect on companies -- employees will want to hold stock in good companies. In most 401(k) plans, workers already have considerable autonomy to diversify both their own contributions and their employer's matching contribution, except for employer stock. This change ensures that autonomy extends to all assets in a worker's 401(k) plan.

The three-year period is not a requirement. Some companies today give their workers immediate freedom to sell employer stock. These companies should be applauded and their practices would be unaffected by the change we are proposing. For other companies, however, the proposed change is a substantial departure from their current practice. In particular, many of these companies want their workers to feel directly invested in their company's future prospects by giving them an equity stake in the company. A three-year wait before guaranteeing workers' freedom to diversify allows employers to build that incentive without locking in a substantial portion of a worker's retirement security to employer stock.

## **Congress Should Not Arbitrarily Limit Employees' Investment Options in 401(k) Plans**

Arbitrary caps have serious drawbacks. They fail to consider that workers make investment decisions regarding their 401(k) accounts in the broader context of their household's complete portfolio of retirement savings. Caps imposed on 401(k) accounts may be easily circumvented, both by employers and employees, and may in fact create incentives for both to do so. Arbitrary caps also would cause disruption in the market for certain large company stock, as substantial amounts of stock in certain companies would have to be sold at once. Caps may also discourage employer contributions to their employees' accounts, leaving the employees worse off. In turn, reduction in employer contributions may discourage workers' participation. Finally,

assets in 401(k) accounts belong to the workers and the government should not arbitrarily restrict how they choose to invest their funds.

*Arbitrary caps ignore workers total retirement portfolios.*

For some individuals, holding higher levels of employer stock within their 401(k) plan may be desirable, particularly if they are well diversified outside of their 401(k) plan. Purchasing employer stock through a 401(k) plan is a tax-effective way for employees to make that investment.

Many 401(k) participants also have defined benefit plans, profit sharing plans, IRAs and personal savings as part of their retirement savings. Thus, participants who may appear to be overly concentrated in employer stock when their 401(k) accounts are viewed alone may be diversified over their portfolio of retirement assets. For instance, a spouse may have retirement assets that the couple took into account when deciding on their asset allocation in the other spouse's 401(k) account. Or a worker may have 401(k) or other retirement assets through a previous employer.

Data gathered in a survey of 401(k) participants undertaken by the Investment Company Institute<sup>2</sup> indicate that:

- Thirty nine percent are covered by a defined benefit plan in addition to their 401(k) plan. (The same survey indicates that employees are likely to hold a higher percentage of total assets in company stock if their employer also offers a defined benefit plan. Respondents who have a defined benefit plan invest an average of 24 percent of overall assets in company stock, while those with none invest only 13 percent in company stock.);
- Thirty three percent have IRAs; and
- Twenty eight percent have spouses who are covered by a 401(k) plan, a defined benefit plan, or both.

Data from a recent survey by EBRI<sup>3</sup> suggest that 401(k) plans are more likely to include company stock as an option if the company also offers a defined benefit plan. In the survey, 60 percent of all 401(k) plans in which there is also a defined benefit plan offer employer stock as a 401(k) option, while only 35 percent of plans without a defined benefit plan do so.

---

<sup>2</sup> *401(k) Plan Participants: Characteristics, Contributions, and Account Activity*, Spring 2000, The Investment Company Institute. The study is based on a random digit dialing sample of telephone exchanges. Sample size is 1,181. Margin of error is plus or minus 2 percent. Half of all households surveyed had only bank or thrift deposits outside their company sponsored plans, 39 percent had stocks, bonds, annuities, mutual funds or real estate besides their primary residence.

<sup>3</sup> Vanderhi, Jack L., *EBRI Special Report, Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members*, January 31, 2002, Employee Benefit Research Institute. This was a survey of members of the International Society of Certified Employee Benefit Specialists. Since the sample is not representative of all 401(k) plans, the results should be interpreted as suggestive of, rather than representative of, the wider population of 401(k) plans.

*Arbitrary caps will be difficult to administer.*

Unlike the 10 percent cap on employer securities held in defined benefit plans, caps in defined contribution plans must be enforced on a participant-by-participant basis. In a large plan, this would necessitate tens of thousands of individual computations annually (or even more frequently). It would also require divestment of employer stock on a participant-by-participant basis, with each participant then needing to give the plan administrator instructions on how to reinvest those proceeds. Efforts to minimize that complexity by using a plan-wide arbitrary cap do not recognize that individuals may have allocations far below the cap. Changes in the value of employer stock and the value of all other assets in the plan further complicate these calculations and complicate the asset allocation decisions each participant must make.

*Arbitrary caps will require a large number of 401(k) participants to sell employer stock that they currently own.*

We estimate that one out of every five 401(k) participants may have to sell employer stock if caps were imposed.<sup>4</sup> The proposed caps would require divestiture at a specified point in time after it has been determined that the cap has been exceeded. Forcing sales of all stock above the cap at a point in time could disrupt the market for those stocks where the amount that must be sold is sufficiently large to affect the stock price. At one major company, for example, enforcement of a 20 percent limit on employer stock holding would precipitate the sale of hundreds of millions of shares, an amount equal to almost 16 times the daily trading volume. At another company, it would be 37 times daily trading volume.

Increases in the market value of company stock could trigger the caps, forcing employees to sell the stock during periods in which it is outperforming other 401(k) assets. This dynamic could particularly disadvantage lower income workers who cannot afford to save outside the 401(k) plans. Higher paid workers would, of course, have the option of using assets outside the plan to purchase the stock once the caps were triggered.

*Arbitrary caps may discourage company matches.*

If most employees hold company stock that is already near the cap, the company will not be able to provide generous matches for new contributions in company stock without exceeding the cap. As a result, rather than making a matching contribution in cash, some companies may choose to reduce or eliminate the employer match. Clearly, workers are better off receiving employer stock as matching contributions to their own 401(k) contributions than receiving no matching contribution at all. Reductions in company matches would likely lead to reductions in the amount of employee savings. Studies show that the amount of a company's match is a key determinant of employee contribution rates.

---

<sup>4</sup> This calculation is based on a BLS estimate of the fraction of participants with the option of investing in employer stock and an EBRI/ICI estimate of the fraction of participants with the option of investing in employer stock who report holding assets above the proposed cap.

*401(k) accounts represent a form of compensation and property that belong to the employees.*

Arbitrary caps on employees 401(k) investment choices challenge fundamental notions of private property rights. 401(k) participant contributions and matching contributions are a form of employee compensation, and government should not restrict or limit employees ability to invest their assets as they see fit. Rather, government policies should promote the ability of employees to make informed, educated decisions about how they wish to allocate their assets. This is why the President's retirement security proposals include a renewed call for incentives for employers to provide employees with free, professional investment advice. It is also why the President is calling for quarterly statements of 401(k) plan performance to empower employees to track and manage their 401(k) assets in a manner best suited to their own individual retirement needs.

*Workers and firms using other tax-preferred vehicles may easily circumvent arbitrary caps.*

Imposing an arbitrary cap on employer stock provides an incentive for companies to use ESOPs instead of company matching with employer stock in a 401(k) plan. Also, with an arbitrary cap on employer stock in 401(k) plans, workers would still be able to invest retirement savings in employer stock through IRA accounts.



## ADDENDUM

### EBRI Survey Result Summary<sup>5</sup>

(Survey Sample Drawn from 3,300 Members of the International Society of Certified Employee Benefit Specialists. *Number of respondents: 375.*)<sup>6</sup>

#### Responses to Factual Questions

- 48 percent of all firms represented in the survey offer company stock as an investment option.
- Restrictions on sale of employee stock.
  - 13 percent of firms that provide *employer stock as a matching contribution* do not restrict the sale of employer stock. 27 percent restrict sales as long as an employee is a participant in the plan; 60 percent lift restrictions after age or service requirements have been met.
- Average percent of company stock in employees' 401(k) accounts in those plans in which company stock is an investment option:
  - In 39 percent of the companies surveyed, employees hold an average of less than 10 percent of their 401(k) assets in the form of company stock.
  - In 42 percent of the companies surveyed, employees hold an average of between 10 and 50 percent of their 401(k) assets in the form of company stock.
  - In 18 percent of the companies surveyed, employees hold an average of more than 50 percent of their 401(k) assets in the form of company stock.
- Only 14 percent of firms represented in the survey restrict the amount or percentage of employer stock that employees can hold in their 401(k) accounts.
- Blackouts
  - 74 percent of respondents reported that their plans have undergone a blackout.
  - 30 percent of the respondents whose plans have undergone a blackout reported that the blackout period lasted two weeks or less, 39 percent reported that the period lasted between two weeks and one month, 31 percent reported that the period lasted more than one month.

---

<sup>5</sup> Vanderhi, Jack L., *EBRI Special Report, Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members*, January 31, 2002, Employee Benefit Research Institute.

<sup>6</sup> Note since this data was gathered from a sample survey it is subject to sampling error.

## Responses to Opinion Questions

- 63 percent of respondents think that the government should limit a plan sponsor's ability to require that matching contributions be invested in company stock.
- 32 percent of respondents think that the government should limit an employee's ability to invest in company stock.
- 93 percent of respondents think that plan sponsors should advise their employees to diversify if company stock is offered as an investment option.
- 61 percent of respondents think that problems resulting from employees investing their own contributions in company stock would be mitigated if employers could provide independent investment advice.
- The respondents are sympathetic with the concept of blackouts. 79 percent think blackouts are fair to employees if they are required for a plan conversion and there is no company stock in the plan. If company stock is part of the plan that percentage falls to 72 percent.
- 43 percent of respondents think there would be a decrease in matching contributions if matching contributions could consist of no more than 50 percent employer stock.